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In the Supreme Court of the United States

OCTOBER TERM, 1957

ARKANSAS-MISSOURI POWER CORPORATION, PETITIONER

v.

MRS. CLARA K. PASCHAL, ADMINISTRATRIX OF THE ESTATE OF ROY G. PASCHAL, FORMER COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF ARKANSAS, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

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OPINIONS BELOW

The memorandum of the District Court (R 23–38) is reported at 144 F. Supp. 272. The opinion of the Court of Appeals (Pet. 1a–9a) is reported at 243 F. 2d 584.

JURISDICTION

The judgment of the Court of Appeals affirming the judgment of the District Court was entered on May 3, 1957. (Pet. 10a.) Taxpayer's petition for rehearing was denied on June 3, 1957. (Pet. 11a.) The petition for certiorari was filed on July

31, 1957. The jurisdiction of this Court is invoked pursuant to 28 U. S. C. 1254.

QUESTION PRESENTED

Whether bonds were issued at a discount when they were issued together with stock in a corporate reorganization under Section 77B of the Bankruptcy Act in exchange for property of the old corporation having a fair market value of more than the face and par values of all the securities issued but less than the fair market value of the stock plus the face value of the bonds.

REGULATIONS INVOLVED

Treasury Regulations 103, promulgated under the Internal Revenue Code of 1939:

> SEC. 19.22 (a)–18. *Sale and purchase by corporation of its bonds.*—(1) (a) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (b) If the corporation purchases any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. (c) If, however, the corporation purchases any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.
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>
> (3) (a) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. (b) If the corporation purchases any of such bonds at a

price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. (c) If, however, the corporation purchases any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price, plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted), over the purchase price is gain or income for the taxable year.

* * * * *

STATEMENT

The taxpayer, the Arkansas-Missouri Power Corporation, originally instituted four separate suits[1] for refund of income taxes, plus statutory interest, in the total amount of $180,762.22 for the years 1939, 1940, 1941 and 1942. The suits were consolidated for trial in the District Court (R. 23). The relevant facts, as found by the District Court (R. 23–31), may be summarized as follows:

The taxpayer was organized under the laws of the State of Delaware as the successor corporation to the Arkansas-Missouri Power Company, an Arkansas corporation (R. 23). On February 21, 1931, the Arkansas-Missouri Power Company (hereinafter also re-

[1] The actions were brought against former Collectors of Internal Revenue and the Acting Collector of Internal Revenue for the District of Arkansas. For convenience, the Collectors will hereinafter in the brief be referred to as the Government.

ferred to as the old company), filed a petition for reorganization under Section 77B, Chapter VIII, of the Bankruptcy Act (R. 26). On the basis of a valuation by appraisers, a plan of reorganization of the old company was evolved which was approved by the district court (R. 27). The plan was also approved by an order of the Public Utilities Commission of the State of Missouri and by the Department of Public Utilities of the State of Arkansas which directed that the amount of securities to be issued under the plan should not exceed the fair value of the property involved in the reorganization (R. 27-28). In its approval the Missouri Public Utilities Commission also stated that in its opinion the amount of the securities to be issued under the plan does "not exceed the fair value of the property involved." (R. 28-29.)

Pursuant to this plan, the taxpayer corporation was organized and acquired all the properties of the old company, taking title thereto on May 1, 1937. As of May 1, 1937, the taxpayer caused to be issued, in exchange for the property of the old company $2,834,640 of first mortgage five per cent bonds due January 1, 1957; $944,880 of six per cent cumulative preferred stock of a par value of $50 per share; and 165,805 shares of common stock with a $1 per share par value (R. 26-27, 30). It recorded the property acquired by it on its books at $4,493,969.94 and also entered on its books at the time of the reorganization a capital surplus of $548,664.94. The fair market value of this property did not exceed $4,084,587.60, or $409,382.34 less than was recorded on taxpayer's

books (R. 29–30). All of the assets were included in their entirety in the mortgage indenture given by the taxpayer to the trustees to secure the first mortgage bond issue. The fair market value of the bonds issued was $2,409,444 (85% of face value); the fair market value of the preferred stock was $680,313.60 ($36.00 a share); and the fair market value of the common stock was $994,830 ($6.00 a share) (R. 30, 31). The reorganization thus consummated and carried out was a taxable reorganization under the federal tax laws (R. 29). The bonds issued by taxpayer were redeemed by 1940 (R. 31).

The issue presented to the District Court was whether the bonds were issued at a discount which could be amortized and furnish the basis for a deduction from gross income. The District Court held (R. 31–38) that, in the circumstances, the bonds were not issued at a discount and entered judgment for the Government. The Court of Appeals affirmed (Pet. 1a–9a) and on June 3, 1957, denied taxpayer's petition for rehearing (Pet. 11a).

ARGUMENT

The decision of the Court of Appeals, affirming that of the District Court, is correct and is not in conflict with the decision of any other Court of Appeals. There is no basis for further review of this case by this Court.

1. The sole issue is whether the taxpayer corporation issued certain bonds at a discount. Both parties agree, and the Court of Appeals recognized (Pet. 8a), that if the bonds were, in fact, issued at a discount,

according to the applicable Treasury Regulations (Treasury Regulations 103, Sec. 19.22 (a)–18 (3) (a), *supra*, pp. 2–3), such discount could properly be amortized over the life of the bonds and the taxpayer would be entitled to a tax deduction reflecting the amortizable amount. See *Helvering* v. *Union Pacific Co.*, 293 U. S. 282. The District Court and the Court of Appeals held, however, that, in the circumstances of this case, the bonds in question were not issued at a discount. The taxpayer's position that the bonds were issued at a discount depends upon an apportionment of the fair market value of the property acquired by it between the bonds and stock issued by it according to their respective fair market values (Pet. 6). Although this method of determining whether bonds were in fact issued at a discount has been upheld in a situation in which there has been arms-length negotiation resulting in a bargained-for sale of bonds and stock in exchange for cash (cf. *Hammel-Ross Fibre Corp.* v. *Commissioner*, 79 F. 2d 474 (C. A. 4); *Pierce Oil Corp.* v. *Commissioner*, 32 B. T. A. 403, 419–421), it is not a proper one in circumstances such as exist in the instant case.[1]

In order to finance by a bond issue, it is sometimes necessary to sell the bonds at a price lower than their maturity value. This discount factor is in reality an additional interest differential which provides an ad-

[1] It should be noted that in the *Pierce Oil* case, there was no dispute concerning whether the bonds were issued at a discount, but rather the question concerned the amount of the discount. See also the comments of the District Court concerning the cases relied upon by taxpayer (R. 36).

ditional inducement to purchasers.[2] Cf. *Montana Power Co.* v. *United States*, 232 F. 2d 541, 549–550 (C. A. 3), certiorari denied, 352 U. S. 843; *New York C. & St. L. R. Co.* v. *Commissioner*, 23 B. T. A. 177, 196; *Hummel-Ross Fibre Corp.* v. *Commissioner*, *supra*, p. 477. Thus, in the usual case of an arms-length, bargained-for sale of bonds, the method of determining whether the bonds were in fact issued for a cash consideration less than their face value, which the taxpayer advances, might be a proper one. But, in a situation such as exists here, where the bonds were not issued in an arms-length, bargained-for transaction, but rather were issued in the course of a reorganization of a bankrupt debtor to its creditors and where the assets of the old corporation were taken over, the same considerations are not present. The issuance price of a bond issue in these circumstances does not reflect an adjustment of the stated interest rate dictated by the condition of the money market, but rather the entire financing of the newly reorganized corporation is controlled by factors which relate to a sound capitalization and a redistribution of interests in the new corporation among the claimants to the old.[3] No plan of reorganization can be

[2] The record shows that no discount was contemplated at the time of the bond issuance. The taxpayer recorded a capital surplus of $548,664.94 (R. 30). Moreover, the Public Service Commission of the State of Missouri found that the securities issued by the taxpayer did not exceed the fair value of the property involved (R. 28–29).

[3] In the reorganization involved herein the District Court engaged independent appraisers of national reputation to appraise the property of the bankrupt prior to its approval of the plan of reorganization (R. 27).

considered fair and equitable within the meaning of Section 77B of the Bankruptcy Act, *supra*, unless the claims of the creditors of the bankrupt are in fact given strict priority in the new entity arising from the reorganization. *Case* v. *Los Angeles Lumber Co.*, 308 U. S. 106; *Group of Investors* v. *Milwaukee R. Co.*, 318 U. S. 523. Before there can be any participation in the new corporation by stockholders of the old, the claims of the creditors of the old company must be fully satisfied. *Consolidated Rock Co.* v. *Du Bois*, 312 U. S. 510.

In a situation such as the present case, the capital structure of the reorganized company, and especially the allocation of capital between bonds and equity securities, is governed by these principles which are substantially different from those governing the usual sale of stocks and bonds for cash. The condition of the money market and other factors which usually determine whether bonds are to be issued at a discount are, at most, secondary considerations in a Section 77B reorganization. The distribution of stock to the prior bondholders gives them an opportunity to participate in subsequent appreciation in values as much as it is a recognition of present worth. All of the assets acquired were included in the mortgage indenture (R. 30) so that the bonds had prior rights to the entire value of the property acquired before the stock had any rights to it. There is therefore no basis for apportioning, as the taxpayer urges, the fair market value of the property acquired between bonds and stocks as though they were being sold to new

investors.[5] It follows that there is no factual basis for the taxpayer's claim that the bonds were issued at a discount.

2. The decision below is not in conflict with that of any other Court of Appeals. None of the cases relied upon by taxpayer to support its apportionment argument involved a situation in which the bond issue arose in a Section 77B reorganization of a bankrupt debtor, which we submit is a crucial factor in this case.[6] Indeed, in *Montana Power Co.* v. *United States*, 232 F. 2d 541, 549 (C. A. 3d), certiorari denied, 352 U. S. 843, three of the judges[7] were of the opinion that the bond discount provisions cannot be invoked in a situation in which there was no arms-length dealing between the seller and purchaser of the bonds. Nor is the decision of the Court of Appeals here in conflict with *American Smelting & Refining Co.* v. *United States*, 120 F. 2d 883 (C. A. 3d), since it is clear from the opinion of the court below that its decision was not based upon the proposition

[5] The fact that the new bonds issued pursuant to the plan of reorganization sold on the open market for eighty-five cents on the dollar (R. 30) has no bearing on whether the bonds were *issued* and paid for at par. Bond discount, as shown by Section 19.22 (a)-18 of Treasury Regulations 103, *supra*, is the excess of the face value over the *issuance* price, and is in no way dependent upon the fair market value. It is obvious that a corporation issuing bonds loses nothing if such bonds are issued at par and immediately thereafter they are sold on the open market by the new owner at a discount.

[6] Taxpayer concedes (Pet. 17) that the question of bond discount arising in a reorganization under Section 77B of the Bankruptcy Act is a novel one.

[7] Judges Kalodner, Staley and Hastie. The Court of Appeals sat *en banc* in its consideration of the case.

that amortizable bond discount cannot arise in an issuance of bonds in exchange for property.[8]

We do not agree that the decision of the court below creates a multitude of problems in the area of amortizable bond discount or has the importance which the taxpayer urges in its petition. The case involves a question which arises only in special circumstances and which, we submit, does not at this time merit consideration by this Court in the absence of a conflict of decisions in the lower courts.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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AUGUST, 1957.

[8] In the view of at least two judges of the Court of Appeals for the Third Circuit the correctness of this proposition has not been finally resolved in that circuit. See *Montana Power Co.* v. *United States*, 232 F. 2d 541, certiorari denied, 352 U. S. 843.

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